

**Reforming the Global Financial Architecture:
Just Tinkering Around the Edges?**

by

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1. Introduction

The 1990s was a tumultuous decade for the international financial system, and especially for emerging-market countries. Capital inflows to these economies increased dramatically. But from 1994 to 1998 the world economy was shaken by a series of financial crises in Mexico, East Asia, Russia and in a number of other emerging-markets. These crises caused major recessions in the affected countries. But, they also served as a wake-up call to policymakers that the existing international financial architecture needs to be reformed.

The surge in capital inflows to emerging-market economies during the first half of the 1990s was driven by high rates of investment relative to saving in these countries and associated high expected returns, financial liberalization and innovation, and lower transactions costs. Simultaneously, investors in the industrial countries increased their supply of financial capital in the belief that international diversification, the explicit or implicit guarantees offered by developing country governments, and the prospect of international bailouts if things went wrong had mitigated the risks of increased exposures to emerging-markets. In retrospect, it is evident that many of the same structural changes that facilitated large capital inflows to these economies also exacerbated outflows when expectations shifted. In such circumstances, pegged exchange rate regimes collapsed and weak banking systems imploded. The international financial architecture failed to forestall these crises or limit contagion. As a result, economic expansions in many emerging-market countries were suddenly thrown into reverse.

From the perspective of the late 1990s, it appeared that emerging-market economies were riddled by crises and that the process of capital account liberalization that many of them had embarked upon was a mistake. Indeed, some commentators have taken the view that the benefits of free capital mobility were grossly oversold.¹ This paper, however, makes a case for the opposite conclusion. We argue that the basic problem was not excessively rapid financial liberalization in emerging-market countries. Rather, it was the inconsistency in the international financial system between the virtually complete markets in which investors in the capital - exporting industrial countries had become accustomed to managing their risks, and the incomplete and distorted market structures in the emerging-market countries to which vast amounts of capital were being

1. See, for example, Bhagwati, Jagdish, (1998) and Radelet and Sachs (1999).

directed. To resolve this dichotomy, both lenders in the industrial countries and governments and corporate borrowers in emerging-markets relied heavily on implicit and explicit guarantees to mitigate the lack of market structures for managing risks. This attempt to 'paper over' a fundamental fissure in the architecture of the international financial system contributed to the abruptness and severity of the financial crises of the 1990s, as well as the striking extent of the contagion that they engendered.

This view of the shortcomings of the present international financial architecture is summarized in the first half of this paper. Such an analysis leads directly to a suggested approach to reform. It is to work systematically to develop a system of broad, deep, and well-regulated financial markets that can more effectively price and manage the risks inherent in capital transfers from industrial to emerging-market countries. This approach, which is outlined in the second half of the paper, addresses the reform of the IMF and other financial institutions, but goes further. It also deals with the relation between the choice of exchange rate regimes by individual countries and the arrangements for providing liquidity to the international financial system, both under normal conditions and in times of crisis. Only by pursuing a comprehensive approach to reform can the international community eventually achieve a more stable and robust global financial architecture.

Section 2 of this paper focuses on the role of financial markets in emerging economies and on the lessons from recent crises. It seeks to explain why, under current international financial arrangements, both emerging-market borrowers and industrial country lenders have had a strong incentive to resort to government guarantees as a way of encouraging capital inflows. It then considers how such behaviour worked to increase the moral hazard inherent in the system. Section 3 sets out the broad outlines of our proposals for a comprehensive, market-based approach to reform of the international financial architecture. This section lays out several broad avenues for change in emerging-market countries: financial sector strengthening; improvements in macroeconomic policy implementation; associated changes in exchange rate regimes and monetary policy targets; and a consistent program of financial market deepening and capital account liberalization. It then considers the role that governments and private sector lenders in industrial countries can play in strengthening the international financial system and in mitigating the effects of crises when they do occur. Section 4 discusses a set of reforms for the IMF and other international financial institutions that would reinforce the proposals in Section 3. It also includes a discussion of how possible changes in the arrangements for private sector involvement in the prevention and resolution of financial crises fits into a comprehensive market-based approach to reform of the international financial architecture. Section 5 summarizes our main conclusions.

2. The International Financial Crises of the 1990s

2.1 Incomplete Financial Markets and the Management of Risks

Although many observers claim that the international financial crises of the 1990s were caused by financial markets that were too unencumbered, we argue that the main underlying cause of these crises was the risks created by the dichotomy between the largely complete and highly transparent financial markets of the industrial countries and the incomplete and distorted financial market structures in the developing world. It is useful to consider how this dichotomy arose.

During the 1960s and 1970s, mathematical economists were much preoccupied with the question of why the structure of markets, even in the industrial countries, remained incomplete. Following on the work of Arrow and Debreu (1954), they reasoned that if more complete spot and forward markets existed, then economies would be able to allocate resources much more efficiently. Why then was it that, in the late 1960s and early 1970s, virtually the only forward markets were those for a few major currencies?

These puzzles have gradually been resolved since the 1960s. Forward and derivative markets did not exist in the 1960s for several reasons: governments and private firms did not make available enough timely and accurate information to allow markets to assess risks effectively; certain key prices in the system -- particularly the exchange rates of the major currencies -- were held fixed; international capital transactions were heavily regulated even in the most advanced countries; and the pricing formulas and raw calculating power needed to process financial information and establish the prices of many financial derivatives simply did not exist.

In the industrial countries, these gaps in the structure of financial markets have been progressively and largely eliminated during the intervening thirty years. First, the shift to flexible exchange rates in the 1970s for the major currencies made spot and forward foreign exchange markets much more responsive as sensitive signalling devices for transactors' expectations of future events. Second, secondary markets and derivative markets for domestic government securities broadened and deepened. Third, flows of timely market information vastly increased. Fourth, as private transactors in industrial countries discovered that virtually any forward contract could be duplicated by a combination of spot market and credit market transactions, there was a tremendous expansion in the availability of financial markets to allow economic agents to manage, hedge, or lay off risks. Fifth, the legal and informational framework that is essential for

efficient markets was greatly extended and refined.² Finally, with the astonishing growth of information technology, algorithms were developed to price complex financial instruments. As a result, markets in the industrial countries have become virtually complete, making them hugely more efficient in allocating resources, both across sectors and regions and over time, and much less susceptible to financial crises.

What has all this got to do the current debate on the future international financial architecture? Quite a lot. As already noted, the crises that occurred during the 1990s were a result of the way in which these virtually complete industrial country markets *interacted* with the incomplete, weakly regulated, and distorted financial markets of capital-importing countries in the developing world. The existence of incomplete financial market structures and weak banking systems in emerging-market economies created strong pressures for industrial country creditors to demand -- and developing country governments to provide -- certain types of implicit and explicit guarantees.

2.2 Financial Flows to Emerging Markets

The seeds of the financial crises that struck a number of developing countries in the mid-1990s were planted by the dramatic growth in capital inflows to emerging-markets that began to accelerate in 1991. Table 1 shows that net private capital flows to emerging-markets increased by more than tenfold between the mid-1970s and the late 1990s. Whereas official capital flows had been the principal source of emerging-market finance in the 1970s and 1980s, by the 1990s they were dwarfed by private capital inflows. The causes of this remarkable surge have been widely discussed.³ Due to rapid growth in Asia and more market-oriented policies in Latin America, these regions became more attractive to foreign investors. Furthermore, because the amount of international investment in emerging-markets had been rather low throughout the 1980s, international portfolio diversification to emerging-market countries was attractive to industrial country investors, particularly with the development of diversified emerging-market index funds and other financial innovations. Whereas bank lending dominated the flows in the late 1970s, foreign direct investment had also become an important source of finance by the late 1990s.

2. In many cases, these refinements were introduced to redress the effects of financial crises in industrial countries that were themselves caused by residual gaps that still remained in their financial market structures. Examples are legion: the collapse of the Bretton Woods exchange-rate system of fixed par values between the late 1960s and the early 1970s; the suspension of the U.S. dollar's convertibility into gold as a result of the Smithsonian Agreement of 1971; the elimination of controls on international capital movements by the United Kingdom in 1979 and most other European countries by the mid-1980s; the major improvements in U.S. financial system regulation in the wake of the crisis in the savings and loan institutions in the early 1980s; the measures taken to strengthen equity market regulation following the stock market crash of 1987; the Basle Capital Accord of 1988; and the improvements in disclosure rules in the Nordic countries' financial systems in the wake of the crises of the early 1990s.

3. For a review of emerging-market financing during the 1990s, see "International Capital Markets: Developments, Prospects and Key Policy Issues", IMF, 1998. See also Schadler et al., "Recent Experiences with Surges in Capital Inflows", Occasional Paper 108, IMF, December 1993.

Table 1: Net Capital Flows to Emerging-Market Economies
(period averages of annual flows, in US\$ billion)^a

	1973-77	1978-82	1983-88	1989-95	1996-99
Foreign direct investment	3.6	9.0	12.6	39.8	133.3
Portfolio investment	0.2	1.7	4.3	41.5	38.5
Other	6.4	15.3	-5.2	33.1	-62.1
Total private	10.2	26.0	11.6	114.3	109.7
<i>Total official</i>	<i>11.0</i>	<i>25.5</i>	<i>29.5</i>	<i>11.7</i>	<i>18.0</i>
Total flows	21.2	51.5	41.1	136.0	127.7

a. Source: IMF International Capital Markets and World Economic Outlook.

Provided foreign capital is invested wisely, over the long term it raises labour productivity, economic growth, and national welfare. Capital inflows, especially foreign direct investment (FDI), also yield dynamic benefits in the form of technology transfers and positive externalities, such as a more highly-trained labour force. Thus, governments in developing countries, many of which already had initiated programs of economic reform and were under great pressure to deliver the promised results quickly, implemented a number of measures designed to encourage foreign borrowing.

However, rather than undertake the time-consuming and costly reforms needed to fundamentally transform their financial markets as a way of attracting and managing these inflows, governments in developing countries tended instead to adopt various implicit and explicit guarantees in an attempt to overcome financial sector deficiencies and reduce risk. These guarantees were welcomed by large institutional creditors in industrial countries, who saw them as a means of limiting risks that could not be hedged because the borrowing countries lacked the markets for doing so. As discussed below, these guarantees aggravated the liquidity, currency and maturity mismatches, thus weakening the risk-return profile that sustained these inflows and setting the stage for the financial crises of 1997-98. The existence of these guarantees also stunted the natural growth of financial markets, Corbett and Vines (1999) underscore the importance of insufficient institutional development as the principal underlying factor of the Asian crisis. This is a view to which we strongly subscribe.

2.3 Lessons Learned

Over-Reliance on the Banking Sector for Intermediation

An important lesson from the emerging-market financial crises of the 1990s is that a resilient national financial system requires that financial intermediation be based not only on a well-developed and well-regulated banking system but also on competition among banks, non-bank financial institutions, and domestic debt and equity markets in channelling funds from foreigners and domestic savers to borrowers in the home economy (Knight 1998, 1999). Since many, if not most, emerging-market economies lack the structure of financial institutions and markets that can compete with banks to intermediate savings, weaknesses in their banking sectors have been rightly viewed as a critical factor contributing to the recent crises (Kaminsky and Reinhart, 1999). These weaknesses have been extensively discussed since the Asian crisis. Nevertheless, it is useful to summarize them briefly, as illustrations of this paper's argument that the dichotomy between complete markets in the industrial countries and incomplete markets elsewhere lies at the heart of the problem with today's international financial architecture.

Miller (1998), among many others, argues that much of the recent financial instability in emerging-market countries is due to an over-reliance on the banking sector to intermediate savings. In the crises of 1997-98, the maturity and currency mismatches on the balance sheets of banks in a number of borrowing countries, coupled with the fact that the first creditors to run were the most likely to be able to avoid capital losses, made banks in these countries highly vulnerable. As funds were withdrawn from banks perceived to be weak, and converted into foreign exchange, interest rates had to be increased to maintain currency pegs. Given the maturity and currency mismatches, these increases in interest rates quickly rendered important segments of the banking system insolvent in the afflicted countries, either directly or via effects on borrowers' balance sheets.

Lack of competition in emerging-country banking sectors has also been identified as a significant weakness. Often this problem has been closely linked to government intervention: nationalization; ownership restrictions; particularly on holdings by foreigners⁴; and lax rules on connections between banks and industrial conglomerates. As a result, banking systems in emerging-market

4. The Meltzer Commission Report (Meltzer, 2000) identifies the lack of foreign participation in the banking sectors of emerging-market countries as a further factor that reduces competition; indeed it recommends that foreign participation in the domestic banking sector be one of the eligibility conditions for emergency IMF lending. Using data for Argentina and Mexico, Goldberg et al. (2000) find that foreign banks maintained credit growth during crisis periods while domestic banks did not.

countries tend to be concentrated, with a large proportion of deposits held in a relatively small number of institutions. This oligopolistic structure has not only led to less efficient intermediation, but has also affected the soundness and stability of banking system in emerging-markets. Oligopolistic banking systems charge higher spreads between loan and deposit rates and provide lower levels of intermediation than competitive banking systems (Knight 1998). Weak competition also results in less effective credit assessment and loan management by such banks. Moreover, oligopolistic banks may engage in destabilizing behaviour as a result of macroeconomic fluctuations. During an economic downturn when the level of nonperforming loans increases, oligopolistic banks may actually tend to increase spreads and reduce lending, thereby putting additional downward pressure on economic activity.

During the 1990s, many emerging-market countries exacerbated these problems by abruptly liberalizing their banking sectors -- through the removal of administrative controls on interest rates, bank-by-bank credit ceilings and limits on new entry -- and by liberalizing short-term interbank claims while retaining tight controls on longer-term inflows of debt, foreign direct investment and equity capital. By maximizing the mismatch between short-term external liabilities and long-term domestic assets, these actions created deep vulnerabilities in developing country banking systems (Knight 1999). And these fundamental changes often took place in conditions where banking supervision and regulation and banks' own risk management techniques were extremely weak (Caprio and Honohan 1999). As a result of these problems, the banking sectors in the emerging-market countries were ripe for just the sorts of crises that befell them in 1997-98.

Capital Markets

Most developing countries also lack the depth and breadth of capital markets that are now found in industrialised countries, and the capital markets that do exist are typically thin and illiquid, particularly at longer maturities. Since such gaps in financial markets limit the information available for risk assessment and risk-pooling, they prevent the efficient transfer of risk across market participants. The most serious gaps and deficiencies include:

- very limited markets for domestic-currency-denominated government and corporate debt;
- thin markets for foreign-currency government and corporate debt, especially long-term;
- limited forward markets for foreign exchange,
- thin and opaque equity markets; and, consequently,
- excessive reliance on debt rather than equity flows.

In most emerging-market countries, only governments and the largest corporations can issue foreign currency debt, and then only at relatively high interest rate spreads over LIBOR and short maturities.⁵ By contrast, the proceeds of these loans, even when they are optimally employed, are typically used to finance investment in highly illiquid forms of fixed capital or imported intermediate inputs. The short maturity of emerging-market debt, coupled with the long gestation period of investment projects, creates a further maturity mismatch risk that usually cannot be hedged in domestic financial markets. This imbalance has often been a source of national balance sheet risk that cannot be easily transferred to other agents, providing yet another factor that contributed to the recent financial crises.

Of course, greater recourse to foreign direct investment or inflows of portfolio equity would have alleviated these severe vulnerabilities. Because equity investors are virtually always 'bailed in' when a crisis arises, and because equity flows are industry- and even firm-specific, they tend to be more stable than debt flows in times of volatility. Indeed, this proved to be the case in emerging-markets during the recent crisis period. While net bank lending dried up and, indeed, reversed, non-debt creating flows remained strong.

Canada's experience is relevant here. External current account deficits were high in Canada during the early twentieth century, at one point reaching almost 18 per cent of GDP. But because these large differences between domestic saving and domestic investment were financed by inflows of foreign direct investment attracted by high expected returns on real capital (rather than by a contractual obligation to pay interest) they did not lead to exchange rate instability.

Although equity markets in emerging-market economies have experienced dramatic growth over the last twenty years, they are still small by the standards of the industrial countries, as Table 2 clearly illustrates.

Indeed, the examples in this table suggest that in most emerging countries equity market capitalization as a percentage of GDP has actually grown less rapidly than in many of the industrial countries.⁶ Furthermore, the equities traded in the local stock markets of emerging economies are predominantly those of the largest local companies or subsidiaries of multinational corporations. Since equity markets in these countries are, in general, not a major factor in

5. The bulk of the foreign-currency debt issued by emerging-market countries has an average maturity of less than 5 years. There are exceptions, however, as some of the larger countries have been able to issue longer-term debt. For example, Brazil, which in the aftermath of its 1998/99 currency crisis adopted fiscal reform and a flexible exchange rate, recently issued 30-year bonds.

6. The apparent exception is Malaysia.

**Table 2: Selected Countries: Stock Market Capitalization
(Percent of GDP)**

	1980	1985	1990	1995	1996	1997	1998
Developed Markets							
Canada	44.6	42.0	42.2	62.3	79.5	89.9	90.0
Germany	8.9	29.6	23.6	23.9	28.2	39.0	50.9
Hong Kong	137.2	99.0	111.5	218.1	291.6	241.6	209.8
Japan	35.8	70.6	98.2	71.4	67.2	52.8	66.0
United Kingdom	38.5	72.2	86.2	125.2	147.8	151.7	169.9
United States	51.8	55.2	52.7	92.7	108.6	136.2	153.6
Emerging-Markets							
Brazil	3.8	18.7	3.5	21.0	28.0	31.1	20.7
Korea	6.1	8.5	43.6	39.9	28.6	9.5	35.7
Malaysia	50.6	52.0	113.6	255.0	309.4	95.1	131.7
Mexico	6.7	2.1	12.4	31.7	32.3	38.9	23.3
Thailand	3.8	5.0	28.0	84.2	55.0	15.3	31.4

Source: International Financial Corporation, Emerging Stock Markets Factbook, 1999, and International Financial Statistics.

intermediating saving flows, domestic firms also have high debt/equity ratios. The heavy dependence of the non-financial sector on fixed interest loans from the domestic banking system is an important source of vulnerability. Finally, in the presence of an explicit or implicit guarantee that the country's exchange rate will remain unchanged, the incentive for domestic borrowers to obtain lower interest rates by borrowing in foreign currency -- even when they are non-exporters who are not "naturally hedged" -- creates strong inducements for domestic banks to borrow foreign currency abroad at short term to make these foreign currency loans to domestic residents, a practice that the current Basle capital rules inadvertently encourages. Thus, even when such banks show a fully-matched foreign currency position, they often bear very large unhedged risks vis-à-vis their domestic borrowers.

The absence of the necessary legal infrastructure (accounting and auditing standards bankruptcy law, etc.) is another factor that causes incomplete markets to persist in developing countries. In advanced economies, well-functioning financial institutions and markets strengthen market discipline by monitoring firm managers and exerting corporate control. In emerging economies, weak or non-existent market discipline makes it difficult for potential investors to assess risks accurately. Thin and opaque equity markets, combined with explicit government policies to limit foreign direct and portfolio investment, also led emerging economies to rely disproportionately on debt flows instead of equity (Table 1). Although this preponderance of debt flows began to attenuate in the early 1990s with the development of emerging-market index funds, these flows remained limited due to political, transfer, liquidity, conversion and exchange risks. Continued reliance on debt financing contributed to the extent of the crises in emerging-markets in the 1990s.

To summarize, all these problems - excessive reliance on banks, as well as major gaps in the structure of financial markets -- have limited the scope for economic agents in emerging-market economies to use market mechanisms to hedge or diversify risk, and have exacerbated financial instability.

2.4 Government Guarantees⁷

The upshot of the above discussion is that the process of transferring capital from industrial to developing countries, though essential to growth, is highly risky. And because of incomplete information and incomplete markets the quantitative extent of these risks -- and the capital that should be held against them -- is virtually impossible to calculate and to hedge. Ultimately, the best way to manage risks in the emerging economies will be to develop well-regulated and efficient market structures. But to do so, it is necessary to have accurate and timely information, and a full web of well-functioning markets that allows agents to diversify risks, supported by a well-functioning legal and regulatory framework. Whenever this comprehensive structure of markets is allowed to take root, risks are events that can be characterized by reasonably well-defined probability distributions, which can be handled by modern pricing formulas for futures and options markets.

But as the previous section illustrates, what happened in emerging-markets in the 1990s was quite different. All too often in developing countries the legal structures to support markets were deficient and lacking in due process, the main banks and other financial institutions employed

7. For a conceptual framework to understand the incentives to seek and grant such guarantees, see Appendix.A

accounting practices that were anything but transparent, thereby giving rise to uncertainties such as transfer risk, political risk and convertibility risk. These are not the sorts of risks that can be characterized by neat probability distributions. Thus, incomplete and imperfect financial markets in the emerging-market countries made the assessment and management of these risks extremely difficult, if not impossible. In order to supply capital to emerging-markets under these circumstances both industrial-country and domestic lenders demanded various sorts of guarantees. And the authorities of many emerging-market countries were quick to offer them. Rather than undertake fundamental financial sector reform, they provided explicit and implicit guarantees to international lenders -- particularly large institutional lenders who thought that if crises occurred they might be able to exert some influence over both host and home governments to take measures to reduce the risks associated with their loans to emerging-markets.⁸

Chain of Guarantees

Dooley (1994) has used the term "chain of guarantees" to describe this behaviour. In his view, and in ours, these guarantees were the "trigger mechanism" for the financial crises of the 1990s. In emerging economies, domestic depositors were often insured by deposit insurance (usually implicit), while foreign lenders to domestic banks or firms were insured by the implicit guarantee that these debts would be assumed by the government should the domestic borrowers default. Furthermore, both lenders and borrowers often were also insured from foreign exchange risk by the government's commitment to a pegged exchange rate, which entailed an implicit promise to protect domestic borrowers from foreign exchange losses. Domestic banks were insured against credit risk on loans directed to, or guaranteed by the government, and against maturity and liquidity risk because the central bank would act as a lender of last resort and the government would not allow the banking system to fail because it was 'too important' to the domestic economy. Hence, the chain of guarantees began with savers and extended through the intermediaries to the ultimate borrowers. Governments were committed to protecting them all. This not only created moral hazard (Eichengreen and Hausmann 1999), which led to excessive risk-taking and eventual collapse, but also precluded the longer-term development of markets to hedge these risks.

To summarize, in the absence of complete markets, both industrial country lenders and emerging-country borrowers and governments had strong incentives to make use of guarantees in their

8. Dooley (1997, pp. 5-6) makes a similar argument. In his insurance model of currency crises, governments want to increase their net reserve position and thus provide guarantees to increase the expected yield on domestic liabilities held by foreign investors.

attempts to limit risk. But when such guarantees were no longer credible, the result was inevitably a crisis as lenders rushed for the exits, creating contagion across whole classes of emerging-country borrowers that were viewed as similar risks, no matter what their individual circumstances. The chain of guarantees lubricated the mechanism that encouraged huge capital flows from industrial to developing countries during the 1990s. But in doing so it vastly increased both creditor and debtor moral hazard.

3. Towards a New Global Financial Architecture

This section argues that in order for countries to reap the benefits of the globalization of financial markets, tinkering around the edges of the international financial architecture will not be sufficient. With the support, encouragement, and assistance of the industrialized countries and the international financial institutions (IFIs), emerging-market countries must take bold steps to broaden the scope and improve the efficiency of their domestic financial markets. Because a broader and deeper set of financial markets will generate more information, improve risk assessment, contribute to more efficient intermediation of domestic and foreign savings, and lead to a more resilient financial system, such efforts will ultimately stabilize capital flows and foster higher and more stable rates of economic growth. Simultaneously, emerging-market countries must undertake the institutional reforms needed to create sustainable exchange rate regimes, supported by a prudent fiscal policy, a low-inflation monetary policy and reforms to further enhance the development of sound and efficient financial systems.

Viewed from this perspective, some recent papers that offer plans for reform of the international financial architecture appear to be too narrowly focused on detailed proposals for changes to international institutions, such as the IMF and the World Bank, and not enough on the reform of the broader global financial architecture itself. There is a sense in which an approach that focuses exclusively on organizational changes to the international financial institutions really is 'just tinkering.'

To appreciate this point, it is useful to look back to the early 1970s when the Brettons Woods system of 'pegged but adjustable' exchange rates was under stress. Years earlier, Robert Triffin (1960) had predicted that the Bretton Woods system of fixed par value exchange rates would eventually collapse. His reasoning was that with exchange rates pegged to the U.S. dollar, and the dollar fixed in terms of gold, the United States would have to run net balance of payments deficits over time in order to provide liquidity to the international monetary system as world GDP

expanded. But these deficits would eventually undermine the credibility of the dollar's convertibility into gold.

The system of fixed par values did collapse, as Triffin had predicted, in the early 1970s. Following that collapse, the plans for reform of the international monetary system that were discussed in the mid-1970s explicitly recognized that a system where the exchange rates of most countries remained fixed would continue to require an ultimate provider of international liquidity. Conversely, if exchange rates were fully flexible, then movements in each country's exchange rate would depend on its own monetary policies and on the shocks to which it was subjected. While it was argued that an emergency lender of last resort would still be needed for countries that were solvent but illiquid, generally the system would not require the provision of a secularly increasing stock of ultimate international liquidity. All this discussion of the international financial system as a system is surprisingly absent these days. But because of the close linkage between international exchange rate arrangements and the need for a provider of international liquidity, the choices that countries make concerning their exchange rate regimes are an essential aspect of any discussion of the reform of the international financial architecture. Indeed, to the extent that countries adopt flexible exchange rates, the need for an ultimate provider of international liquidity is reduced.

A second problem with some recent proposals for international financial reform is that they do not begin by stating a clear set of objectives that are to be achieved. We take it as given that the key objectives for reform of the global financial architecture should be threefold: (1) to minimize instances of international financial crises in all countries; (2) to limit the degree of contagion that occurs when a crisis in one country is transmitted to other countries in the same 'asset class' whose external positions would otherwise be viable; and (3) to resolve crises, when they occur, in ways that avoid both moral hazard on the one hand, and an excessively severe macroeconomic adjustment burden in the crisis countries on the other.

To provide an adequate plan for an international financial system that will achieve these objectives, we must look not only at reform of international financial institutions like the IMF and the World Bank, but also at the way financial markets, exchange rate regimes, and macroeconomic policies function in the world economy. Much ink has recently been spilt on this topic, and few of the suggestions offered here will be viewed as original. However, the proposals made here will show how our conclusions flow logically from the preceding analysis, which emphasizes the dichotomy that exists when substantial amounts of capital are being transferred over long periods from regions that have largely complete markets to those where there are

serious gaps in market structures. Hopefully, this line of reasoning may shed additional light on these fascinating questions.

In essence, our reform proposals emphasize the need to foster an increased role for market forces in managing the large net flows of capital from industrialized to emerging-market countries that are likely to occur for decades to come. Consequently, we reject the proposals to reintroduce capital controls that have been made by some observers. Such controls, even in the rare cases where they are effective, create severe economy-wide distortions and encourage corruption.

Our proposals underscore the importance of encouraging the development of more complete markets in emerging economies. This will require considerable effort and time on the part of emerging-markets themselves, but also on the part of industrialized countries and international financial institutions. Emerging-markets, supported by the international community, need to work steadily towards upgrading their financial infrastructure (e.g., their legal frameworks, accounting standards and disclosure requirements) as well as strengthening financial system regulation and supervision. Such improvements are essential for the development of effective markets. Borrowers and lenders must also be weaned from their reliance on government guarantees. Through a better alignment of risk and reward, the elimination of such guarantees will permit markets to function properly. And these proposals inevitably include principles for the development of a stable macroeconomic policy environment, including a sustainable exchange rate regime, that will facilitate non-inflationary long run growth, and provide the underpinnings for further deepening of emerging-market financial systems. Finally, the roles that international financial institutions and the private sector can play within this proposed structure is articulated.

Through the implementation of these proposals, the emerging-market countries will be able to turn financial market globalization to their advantage by benefiting not only from less expensive access to capital but also from stronger market discipline which, along with strengthened prudential oversight, will serve to improve the stability and resilience of domestic financial systems. Thus the 'silver lining' of the recent crises in emerging-markets is the impetus they provide for governments to overcome the political obstacles to fundamental market-enhancing reforms.

3.1 Domestic Financial Sector Reform

Financial Infrastructure Reform

The key areas for financial infrastructure reform are well known: accounting and auditing practices; stronger corporate governance and insolvency laws; timely and accurate public disclosure of financial data; more effectively risk proofed payment and settlement systems; strengthened supervision and regulation; and more effective market discipline. Of course, a basic step is for the emerging-market countries to strive to undertake the reforms necessary to implement the international standards and best practices that are being formulated in various fora. The draft report of the Financial Stability Forum (2000) catalogues the standards and codes that have been developed over the past several years. While the Basle Committee's core principles for effective banking supervision and the IMF's codes of transparency for fiscal policies and for monetary and financial policies are central elements, the Forum's catalogue lists a large number of standards and best practices that pertain to most aspects of a country's financial system.

Although the adoption of such standards should be voluntary, market participants' recognition that a country is implementing such codes and standards can help to strengthen its reputation as a well-managed destination country for international capital flows. Linking progress on the implementation of standards to eligibility for IMF assistance may also provide a strong incentive for emerging-markets to take action. The IMF is already extending its work to assess countries' compliance to these standards, often at the request of the member country concerned, or in the context of its regular Article IV consultations and Financial System Stability Assessments for individual member countries. We believe that these assessments should eventually be made public.⁹ Many recent papers on international financial reform have called on the IMF and the World Bank to play a larger role in accelerating these reforms by providing or coordinating technical support. This is, of course, appropriate. But such exhortations should not overlook the extensive work that these two institutions have already done, since the early 1990s, to strengthen financial systems in emerging-market countries. To cite just two examples, starting in 1996 the IMF and the World Bank were active in encouraging the Basle Committee's work to develop its core principles of effective banking supervision. Similarly, Knight et al. (1998) describe the work done by the IMF since 1991 in coordinating a large program of technical assistance provided by

9. The IMF has begun to undertake Financial System Stability Assessments (FSSAs) in the context of its Article IV consultations with selected countries. Peer review by experts in various aspects of financial system stability is an important aspect of the IMF's work in this area. Canada was the first of the G-7 industrial countries to accept an IMF Financial System Stability Assessment.

experts from advanced country central banks, the IMF, and the World Bank to all 15 countries of the former Soviet Union to help them develop their central banking institutions and to establish modern, well regulated financial systems.

Banking Sector Reform

Clearly, the first step in strengthening emerging-market financial systems must be to eliminate implicit and explicit guarantees made by governments to, or on behalf of, domestic banks. Directed lending by domestic banks to preferred domestic firms and guarantees on foreign loans to private borrowers should also end immediately. Reasonable economic arguments can be made for limited deposit insurance and the lender of last resort functions. However, deposit insurance schemes should be self-financing, and lender-of-last resort facilities should be subject to explicit and transparent rules, and the central bank's and government's exposure should be limited.

In the wake of recent crises, the banking sectors in a large number of emerging-market countries remain weak and vulnerable. Thus the most pressing reform in the affected countries is the recapitalization and restructuring of the banking sector, as well as a fundamental strengthening of regulation, prudential supervision, disclosure, and market discipline. To accelerate this process, countries are being encouraged to allow foreign banks more scope to enter the domestic banking sector and to acquire under-capitalized or otherwise troubled domestic banks. Foreign banks can inject the capital needed to return domestic banks to viability, thus potentially lowering of the burden for local taxpayers. They also bring with them the strong accounting standards, disclosure requirements, and risk assessment and management practices, that are required by supervisors and private investors in their home country.¹⁰ Foreign entry also encourages competition, thus instilling stronger market discipline and greater resilience to shocks, by forming asset pools that are more diversified across countries, industries and asset classes. Simultaneously with recapitalization, significant steps must also be taken to improve bank regulation and supervision along the lines of the Basle Committee's *Core Principles for Effective Banking Supervision* and its other, more detailed, standards. Perhaps the most important caveat here is to avoid a situation where the owners and manager of banks that became insolvent the last time round are allowed to retain a financial interest and/or operational control of the restructured institutions.

10. Gavin and Hausmann (1997) make a similar argument.

Capital Market Deepening

The financial infrastructure reforms outlined above will have a large impact on capital markets because these markets trade standardized instruments whose values depend critically on transparent and enforceable regulations governing accounting and auditing practices, bankruptcy and corporate governance. Capital markets can only operate efficiently if investors believe that they have reasonable access to fundamental information about the financial condition of debtor governments and firms. Once again, the rules on disclosure and governance are critical.¹¹

Some commentators, most notably Hausmann (2000), have argued that many emerging-market countries, primarily those in Latin America, will not be able to issue debt in their own currency, especially of longer maturities, for the foreseeable future because of “original sin”. That is, past macroeconomic policies have been so ineffective that even if the authorities try to institute the appropriate reforms they will not be able to undo past wrongs, for at least a generation.¹² But this conclusion may be excessively pessimistic. Chile, and Mexico have successfully expanded and deepened their capital markets in recent years, and they have made some progress in developing markets for domestic-currency-denominated instruments and in lengthening the maturity of their debt.

3.2 Macroeconomic Policy Reforms in Emerging-Market Countries

The objective of domestic macroeconomic policy reform should be to attain a coherent and transparent framework that helps to assure the sort of stable low inflation environment that is conducive to long-term economic growth. This means implementing a sustainable fiscal policy, a monetary policy that targets an appropriate nominal anchor, and an exchange rate regime that is consistent with the monetary policy framework.

Sustainable Fiscal Policy

The fundamental starting point for a credible macroeconomic policy reform is implementation of a firm fiscal policy that establishes a “virtuous” set of debt dynamics. Until the Asian crisis

11. Standards have also been proposed for the regulation and supervision of securities and insurance markets: *Objectives and Principles of Securities Regulation* by the International Organization of Securities Commissions and *Insurance Supervisory Principles* by the International Association of Insurance Supervision.

12. Hausmann thus recommends that these countries should dollarize because the reforms will not have any immediate and substantial effect on interest rate spreads.

erupted in 1997, by far the most frequent cause of economic problems in developing countries was excessive fiscal deficits financed by money creation. Unfortunately, it normally takes a lengthy period of poor economic performance for fundamental changes in fiscal policy to be achieved (Eichengreen 2000). The simple rules of thumb are that government debt should not be increasing as a proportion of GDP, and ideally should be falling, and that any fiscal deficit should be financed by government borrowing from the private sector rather than by monetary expansion.

The Exchange Rate Regime

Assuming a sustainable fiscal policy, the central bank can choose -- and credibly commit to -- a nominal anchor from the following set of options: a permanently fixed exchange rate, a path for monetary aggregates or a price level/inflation rate target.

For many emerging-market countries, an important element of the recent crises and their propagation was the commitment to a pegged exchange rate. Whenever a crisis arose, this commitment provided a one-way bet to speculators so that speculative outflows became self-fulfilling. As already noted, the implicit guarantee afforded by the pegged exchange rate also encouraged excessive borrowing in foreign currency by domestic residents, making them highly vulnerable to devaluation.¹³ The difficulties of the 'pegged-exchange-rate trap' are an important lesson from these crises, and they form the basis for one of the central and most widely-accepted recommendations for global architecture reform: namely, that emerging countries should adopt a 'polar' exchange rate regime, either permanently fixed or fully flexible.¹⁴

For each country, the choice of exchange rate regime will depend on a number of factors. Typically, countries that are small, have small non-traded goods and services sectors, have a large share of their trade with a large currency bloc, and are unlikely to be subjected to real shocks that differ from those that affect their main trade and financial partners, may choose a fixed exchange rate as their nominal anchor. Given recent negative experience with traditional adjustable pegged arrangements, such countries should choose among a currency union, a unilateral adoption of their main trading bloc's currency, or a currency board. Provided that the trading bloc is able to maintain reasonable price stability, this approach will tend to stabilize the consumer price deflator

13. During the 1990s, private agents seemed to act on the basis that exchange rates in a number of emerging-market countries would remain fixed, despite the fact that interest rate spreads generally implied that there was a non-zero probability of devaluation. Although this behaviour may seem irrational, past experience and government pronouncements may have led them to believe that the government's commitment to the peg was credible, or that in the event a devaluation took place, political pressure would force the government to bail out domestic borrowers in foreign exchange.

14. For example, the Council on Foreign Relations Task Force Report (Goldstein, 1999) recommends a managed flexible exchange rate for most emerging-markets with a currency board or common currency reserved for special situations.

in the small country. The small country will also reap the microeconomic gains from being a part of a large bloc that uses a single vehicle currency as a medium of exchange and store of value. However, these microeconomic gains, while significant, are probably smaller now than they were in the past, before information technology and market development sharply reduced the cost of making exchanges from one currency to another.

Conversely, if a country has a reasonably large non-traded goods and services sector and is likely to be subject to asymmetric real shocks -- that is shocks that affect its production and consumption patterns differently from the way they affect its major trading partners -- and if it has the institutions and instruments necessary to be able to target a domestic nominal anchor, then a flexible exchange rate would be a better choice.

Provided a flexible exchange rate is anchored by a credible monetary policy, it has many attractions, not only for industrial countries, such as Canada, but also for a growing number of the larger, more sophisticated emerging economies. If the domestic price level is well tethered, a flexible exchange rate facilitates adjustment to external capital flows and demand shocks, and thereby stabilizes output, employment and consumption.¹⁵ Given an asymmetric shock, for example a fall in the terms of trade, a decline in the real exchange rate can be a key element of the adjustment process. It makes both the export sector and import substituting sectors more profitable, while import activities become less profitable, so that economic activities are redirected in ways that offset the effects of the negative external shock. Moreover, during periods of large capital inflows, letting the real exchange rate appreciate via an appreciating nominal exchange rate rather than through higher domestic prices under a fixed or pegged rate reduces the likelihood of persistent overvaluation when circumstances change and domestic assets are less attractive.¹⁶ Ortiz (2000) has recently discussed the useful role that Mexico's flexible exchange rate played in external adjustment during the recent slump in world commodity prices.

A flexible exchange rate allows countries to choose their own inflation rate within a coherent and transparent monetary policy framework. It eliminates the implicit exchange-rate guarantee on foreign borrowing and the associated moral hazard. Thus, it obliges domestic borrowers and foreign lenders in emerging-markets to manage this risk more effectively, and also, tends to foster the development of forward and futures markets, as has taken place in Chile and Mexico.¹⁷

15. Osakwe and Schembri (1999) demonstrate using a sticky-price rational expectations model that a flexible exchange rate will generate more stable output than either a permanently fixed exchange rate or a collapsing fixed exchange rate.

16. Murray (1999) provides a good assessment of the benefits of a flexible exchange regime for Canada, an industrialized country which also experiences large external demand shocks.

17. Obstfeld (1999) and Mishkin (1998) make similar arguments.

Finally, from a global perspective, flexible exchange rates provide a public good because the need for an ultimate provider of international liquidity is reduced *pari passu* with the extent of floating. And, since a flexible rate reduces the likelihood of financial crises, calls for emergency 'bailouts' of afflicted countries by creditor countries or the IMF would be less frequent, thereby significantly reducing the degree of moral hazard in the system.

A Clear Domestic Nominal Anchor

A country that wishes to pursue an independent monetary policy and, consequently, chooses a flexible exchange rate, needs to find a clear, domestic monetary policy anchor. Canada's experience with direct inflation targets since 1991 may be relevant to emerging-market countries. Although Canada is an advanced industrial country, primary commodities constitute a relatively large proportion of output and exports. The combination of a flexible exchange rate, which Canada has had in all but 13 of the past 55 years, and inflation-control targets, in place since 1991, has served Canada very well. This combination has successfully reduced inflation from relatively high levels in the 1980s and at the same time has maintained solid economic growth. It represents a transparent monetary framework that the a number emerging-market countries may find attractive.

Canada's inflation-control target range of 1 to 3 per cent operationalizes the Bank of Canada's objective of achieving a low and stable rate of inflation that will create the necessary environment for a well-functioning economy. An explicit inflation target has many benefits. In particular, it clarifies the central bank's objective and thereby helps to anchor inflation expectations. The Canadian experience strongly suggests that a policy framework of inflation targeting and a flexible exchange rate is a powerful combination for achieving domestic monetary stability with external balance. In Canada, direct inflation targeting now provides a transparent nominal anchor while the exchange rate is permitted to vary. This has helped the economy to adjust to asymmetric shocks to our terms of trade, or to changes in the demand for Canadian assets by foreign investors.

An important question is whether the monetary framework and experience of Canada and other industrial countries, such as New Zealand, Sweden or the United Kingdom, can be extended to emerging-market countries. Clearly, it is unrealistic to assume that countries with a history of fiscal imbalances, inflationary monetary policies and financial instability can transform themselves overnight into a situation of economic and financial stability comparable to that of an industrialized country. However, the relevance of direct inflation targeting does not appear to be

limited only to industrial countries. It is now being tried, with solid early success, by emerging-market countries such as Mexico, and more recently Brazil and Chile.

Indeed, the success of the latter three countries suggests that credible macroeconomic policy reforms may yield good results in a relatively short period of time. Nonetheless, even if this policy framework cannot be adopted initially, it may be worth achieving over the medium term. Indeed, we believe that the market structures needed to implement monetary policy and to deepen the financial system may actually develop more effectively under a regime of direct inflation targeting.

Monetary policy credibility in an emerging-market country is an essential prerequisite for developing the fixed income markets, particularly at the longer end. Ultimately this will give the authorities better objective indicators of market expectations and more information to undertake their monetary operations. And of course, the awareness that -- with a flexible exchange rate and an independent monetary policy that targets price stability -- changes in fiscal policy that are not viewed as sustainable will immediately have an impact on the exchange rate. Thus, directly targeting a low stable rate of inflation imposes considerable discipline on the domestic fiscal authority as well.

If a country has a flexible exchange rate and a credible monetary policy, we would also argue that capital account liberalization is made much easier. Relatively free capital mobility is important in order to help ensure that large but temporary real shocks do not result in excessive or prolonged appreciations or depreciations of the real exchange rate. Thus, freer capital mobility can be an important element in a smooth external adjustment process.

In summary, in a globalized financial system, countries should adopt either a permanent fixed or a flexible exchange rate regime. However, based on the experience of a number of countries, both industrial and developing, it is our view that the adoption by more countries of a monetary framework with explicit inflation targets and a flexible exchange rate would improve the international financial architecture by extending market structures, reducing or eliminating the use of guarantees to encourage capital flows, and limiting the need for an ultimate provider of international liquidity, either on an ongoing basis or in crisis situations. Choosing such a monetary framework, therefore, carries the prospect of profoundly reducing moral hazard.

4. The role of international financial institutions

Much has changed since the early post World War II period when the International Monetary Fund and the World Bank began their work. New international financial institutions such as the regional development banks, have been created through the years. And these all institutions have evolved in new directions in response to changing circumstances. Since the late 1980s, international capital markets have also expanded far beyond what the architects of Bretton Woods could have imagined. Private flows now dwarf official flows to emerging-markets. For many developing countries, lending by development banks and other official sources has become of secondary importance. As the IFIs have evolved, the division of labour between the World Bank and the IMF has changed markedly. The World Bank has participated in crisis assistance while the IMF has lent to countries to assist economic development. Although close cooperation among IFIs is essential, each institution ought to have a clear mandate and a specific focus.

We strongly believe that in an inter connected global economy there is a continuing need for international financial institutions. Notwithstanding large private capital flows, the World Bank and the regional banks can still play a useful role in helping to finance projects in developing countries that have a high social rate of return. They can also provide invaluable technical assistance in institutions-building and good governance. But central to the whole system is an international surveillance institution, and the IMF fulfills that essential role. Indeed as argued below, we see the Fund's role more as a provider surveillance, of information on macroeconomic conditions and as a neutral third-party adviser rather than as a lender. We will argue that its own lending should be limited in the future, with the emphasis given to creditors and debtors resolving their financial problems themselves.

4.1. The role of the Fund in a globalized financial system

The increasing adoption of floating exchange rates and the surge in international capital flows in the 1990s have led to numerous calls for IMF reform. Opinions on this subject range from advocating the abolition of the Fund to turning the IMF into a *bona fide* international lender of last resort. In an important sense, one's view of the scope of the IMF's role as a provider of liquidity to the international financial system depends on one's view of how well financial markets can be made to operate, particularly in the emerging countries. We believe that financial markets generally work well in allocating capital if incentives are not distorted. This suggests that the IMF should play a limited, catalytic role in providing finance for crisis resolution.

Surveillance and Advice

Thus we emphasize the Fund's large comparative advantage in undertaking surveillance over the macroeconomic policies of its member countries, collecting and disseminating data, assisting financial negotiations during crises, and providing technical assistance to less developed members. The IMF is uniquely placed to undertake economic and financial surveillance by evaluating the macroeconomic policies of its member countries in the context of its Article IV consultations and its program negotiations and program reviews. In recent years, however, pressure from member governments have obliged the Fund to address an increasing number of issues that are ancillary to its central role in assessing macroeconomic performance. We believe that the Fund should be allowed and encouraged to focus on its acknowledged areas of expertise -- monetary policy and fiscal policy, and policies relating to the national balance sheet and debt sustainability. It is also desirable for the Fund to have a major role in assessing its members countries' financial systems because of the close link between financial system weakness and macroeconomic stability.¹⁸ Finally, given its universal membership and existing surveillance procedures, the IMF is best placed to be the agency to monitor and publicly disseminate information on countries' compliance with international codes and standards. This includes the codes of conduct that it has developed itself, such as the those on data transparency and on fiscal, monetary and financial policies, as well as those developed by specialized groups in areas outside of the Fund's competence. To date, more than sixty such standards have been drafted or are under development. As these specialized groups were established as rules-making bodies, they do not have the resources to monitor and encourage compliance. Consequently, this task is likely to fall to the IMF by default.

In 1999, the Financial Stability Forum (FSF) -- consisting of financial regulators, central banks and treasury officials of G-7 countries -- was established to exchange views on international vulnerabilities and establish priorities and action programs. To help emerging-markets set priorities, one FSF working group focused on determining which codes and standards are the most important and how to implement them. Key standards for sound financial systems have been identified covering macroeconomic fundamentals, institutional and market infrastructure and financial regulation and supervision. Other FSF working groups have also completed useful work on highly leveraged institutions, off-shore centres and capital flows. The G-20 group of industrial and systemically-important emerging-market countries provides a useful forum for developing the

18. See Lindgren et al. (1996). Our recommendations concur with those of last year's external evaluation of Fund surveillance.

international consensus, political support, and direction needed to implement standards and codes, as well as other key element of architectural reform, such as sustainable exchange rate regimes and sound asset-liability management.

The Fund and Crisis Management

Owing to its role in assessing macroeconomic policies, balance-of-payments and debt sustainability in each of its member countries, the IMF should continue to play a central role in resolving financial crises when they occur. But, particularly for countries which have been accessing private capital markets, this does not mean that the Fund should be the only, or the first, or the largest, lender in crisis situations. As recommended by Goldstein (1999), the Fund should encourage the formation of standing steering committees composed of holders of emerging-market bonds and bank loans. It should work with these committees and with representatives of the borrowing country during liquidity crises and debt rescheduling negotiations. Litan argues that the IMF's relatively scarce financial resources in the face of massive capital flows make its role as a crisis manager even more important than its role as an international lender.¹⁹ In summary, for market-borrowing emerging-market countries that experience crises, the Fund's primary role should be that of a facilitator, assessing the prospects for macroeconomic adjustment, debt sustainability and external financing as a means of carrying forward negotiations between creditors and debtor countries.

IMF Lending

The above sections suggest that the extent that a reformed international financial system includes a larger number of countries that practise exchange-rate flexibility, the role of the IMF in surveillance will deepen and expand, but its role as a large-scale and long-term lender will atrophy. This, indeed, was the case for the industrial countries when, with Canada in the lead, they adopted widespread floating in the first half of the 1970s.

Some observers have argued that the frequency, virulence and spread of financial crises in emerging-markets suggests a need to turn the IMF into an International Lender of Last Resort (ILOR).²⁰ We believe, however, that moral hazard concerns militate against such an extension of the Fund's role. The prospect of international assistance to supplement international reserves for defending a pegged rate or to bail out foreign lenders can be viewed as yet another link in the

19. See Litan, Robert E. (1998). *Does the IMF Have a Future? What Should it Be?* mimeo. October 1998.

20. See Fischer, S., "On the Need for an International Lender of Last Resort," 1999.

chain of guarantees discussed earlier that can distort the actions of borrowing countries in favour of more expansionary policies (debtor moral hazard) and, more importantly, bias the credit allocation decisions of private lenders (creditor moral hazard).²¹ In addition, when a crisis hits, as long as official money is 'on the table,' there is reduced incentive on the part of the debtor and its creditors to sit down and negotiate a debt restructuring. Indeed, access to official funds might only accentuate the race for the exits by providing a willing counterparty. In such circumstances, the Fund acts as the lender of first resort, rather than last resort.

The solution to this problem lies in establishing a framework for greater private sector involvement in the resolution of crises. Strict limits on the scope of IMF lending (and of the official sector more generally, either through other IFIs or through coordinated bilateral support) to countries in crisis would limit creditor moral hazard. No longer would there be the prospect of large official financial assistance packages, and no longer would countries have extensive access to public funds to try to sustain pegged exchange rates that were no longer appropriate. By the same token, consideration should be given to a penalty interest rate that would escalate over time, as well as short maturities for IMF assistance to limit debtor moral hazard and ensure that countries exhaust private options before approaching the official sector. (See appendix B for some suggestions on arrangements for IMF lending.)

4.2 Private sector involvement in crisis resolution

As emphasised by King (1999), in an international financial system dominated by flexible exchange rates, a country is most likely to experience a crisis when it has mismanaged some aspect of the liquidity, maturity, or currency structure of its national balance sheet. In such circumstances, how can the international community best address financial crises? Clearly, in cases where a country has been accessing private international capital markets, the onus must be on the debtor country and its private creditors to find a solution. The IMF can play a key role as a broker in assisting this process, as long as it is not itself a large lender. It is the entity with the expertise and objectivity to assess what is likely to be optimal in terms of macroeconomic adjustment as well as to determine what debt profile would be sustainable over the medium term.

A voluntary rescheduling of debts is the preferred outcome of any negotiation between a debtor and its private creditors. However, it is conceivable that a debtor might be forced to declare a

21. The most egregious case of creditor moral hazard was Russia which was viewed as being too geopolitically important to fail prior to the summer of 1998. Indeed, lending to Russia was called the 'moral hazard play.' More subtly, private credit raters explicitly take into account the prospect of receiving international assistance when awarding ratings to countries.

standstill, including, possibly, the introduction of temporary capital controls, to limit capital outflows and provide an opportunity for negotiations on a debt restructuring, or even debt reduction if the problems are very serious.

Standstills are one way of dealing with the coordination problem in the presence of a restive group of private creditors, all with differing interests. It is important to underscore, however, that a standstill can be of benefit to both the debtor and creditors. It provides time for the debtor to get its house in order, thereby potentially preserving value for creditors. Additional mechanisms to address the collective action problem should be considered. On going communications between a debtor and its private-sector creditors and the establishment of standing creditor associations are avenues worth exploring. The introduction of collective action clauses in sovereign debt instruments should also be encouraged. While collective action clauses would not have been much help in dealing with the crises in Asia and Brazil, they were useful in helping to restructure the debts of Ukraine. Looking ahead, as countries rely more on bond financing relative to bank loans, the value of collective action clauses is likely to rise. Reflecting the importance of this issue and the merit in leading by example, Canada recently agreed to introduce such clauses in its own foreign bond covenants.

In sum, while the case for an international lender of last resort is superficially appealing, it is not convincing. Instead, reliance should be placed squarely on the shoulders of the debtor and its creditors to resolve financial problems. Only then will the incentives be in the right place. While the Fund can provide limited amounts of resources to help 'grease the wheels,' its role in crisis management should be primarily to provide information, analysis and advice, and to undertake a coordinating role in helping to bring debtors and creditors together.

5. Concluding Remarks

What is truly new about the 'new' global economy is the unprecedented and growing influence of global capital markets, a development which is likely to continue for years to come. To cope well with this new reality, further substantial steps to strengthen the international financial system are needed. This paper suggests that it must be fundamental reform. It cannot involve 'just tinkering around the edges' if we are to meet our objectives of minimizing the occurrence of future crises and the risk of contagion, as well as resolving crises when they occur in an expeditious fashion that avoids both moral hazard on one hand and excessive macroeconomic adjustment in crisis countries on the other.

The suggestions in the paper should constitute a broadly acceptable, reasonable, a comprehensive, market-based approach. It will lead to the development of more complete markets in emerging economies and will place the responsibility for crisis prevention and resolution on the shoulders of debtors and creditors, with the IFIs, and the international community more generally, showing the way rather than trying to carry the burden. Emerging-market economies must break new ground in their efforts to reform their financial sectors and their monetary framework, and wherever possible industrial countries should provide effective technical assistance for doing so. Government guarantees and other government-induced distortions in the financial sector should be removed and international standards and codes on disclosure, financial sector regulation, insolvency and corporate governance must be implemented. To strengthen further the domestic financial sector, and indeed the rest of the economy, macroeconomic institutions and policies should be reinforced. In this regard, we favour the adoption of a flexible exchange rate and inflation targets by the larger, more sophisticated emerging-market economies.

The IFIs, chiefly the IMF, should support these changes by providing surveillance and policy advice and by collecting and disseminating data. The IMF should encourage the adoption of internationally developed codes and standards by releasing surveillance reports. With the assistance of the IFIs and the rest of the international community, reforms aimed at achieving more complete financial markets, low inflation and a flexible exchange rate, should greatly reduce the number of financial crises. Should they occur, however, we believe that IMF lending should generally be in the form of short-term emergency loans in limited amounts. The large bailout packages of the 1990s should become a thing of the past, and be replaced by mechanisms, possibly including standstills, that ensure that risks as well as the rewards of lending are borne by creditors and debtors instead of the international community.

The reform agenda is large and requires widespread support to be realized fully. But the potential gains to world welfare are also large and should provide the incentive for countries to overcome political obstacles to global financial architecture reform.

APPENDIX A

Emerging-Market Economies and the Incentive for Guarantees:

A Simple Conceptual Framework

To understand the incentives to seek and grant such guarantees, we can use a simple one-period model. Consider the two-quadrant diagram in Figure 1 with the vertical axis representing the expected rate of return on domestic assets less the return on the risk-free international asset, say U.S. Treasury Bills. In the right quadrant, an upward-sloping risk-return frontier is shown for the available set of domestic assets with the standard deviation of the return on the horizontal axis. For convenience, the risk-return frontier is assumed to be continuous, but in practice it may not be because the set of domestic assets available for foreign investors may not be sufficiently large. It slopes upward because in an efficient market, a higher expected return can only be obtained by taking on more risk. In the left quadrant, the foreign capital supply curve is drawn with the amount of foreign capital inflow (net) on the horizontal axis. It slopes downward, implying that to attract more foreign capital the expected return differential on domestic assets must be higher.²²

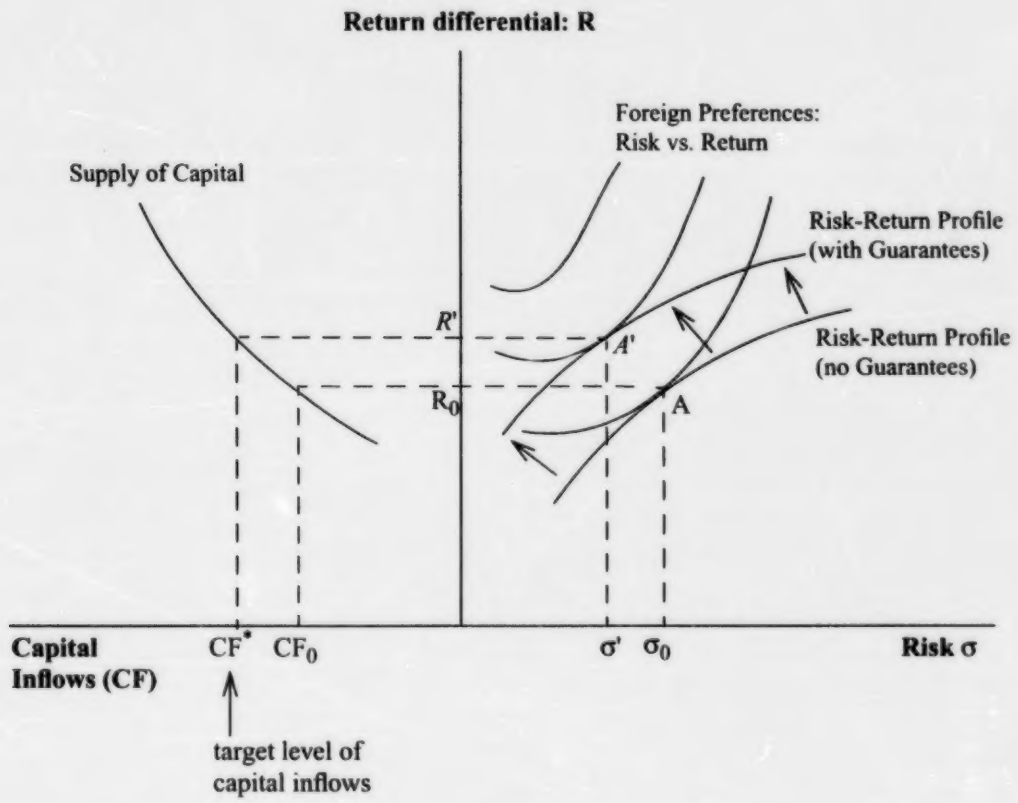
Also in the right quadrant, a set of indifference curves can be added reflecting the risk-return preferences of a representative foreign investor. Given the risk-return frontier, the optimal portfolio of domestic assets held by foreigners is given by the point of tangency between the frontier and the highest indifference curve, represented by the point A. This point gives the equilibrium expected return differential and the level of foreign capital inflow.

Now suppose this level of capital inflow is below the desired level. To increase capital inflows given the preferences of foreign investor, the national authority must find a way of shifting the risk-return frontier upwards to the left, that is, some mix of increasing expected returns and reducing risk. Consider two extreme options: one, undertake economic reforms, in particular with respect to the financial sector that could raise expected returns by increasing economic efficiency and reduce risk by providing efficient risk transfer; or two, provide guarantees to limit the risk foreign investors face. (Note that government guarantees may not ultimately reduce the risk because these guarantees may not be sustained under certain outcomes.) Such guarantees could be represented by a horizontal shift in the risk-return frontier. Note that the expectation of an IMF bailout would have similar effect as investors would perceive a reduction in risk and take on riskier than otherwise investments.

22. Given that foreign capital inflows will also depend on risk, which increases with expected return, it is possible that for high levels of risk the curve may bend and become upward sloping. For simplicity, we assume this possibility is outside our range of interest.

This “quick-fix” approach of guarantees to attract foreign capital and accelerate the rate of economic development led national authorities to neglect the hard longer-term task of strengthening their financial systems to manage capital inflows so that they would be a stable, assured source of external financing over the longer term. Instead, the focus of public policy in these countries was to encourage these inflows over the short to medium term, rather make the substantial long-term investment in legal and financial infrastructure required to ensure that these flows were being efficiently intermediated and thus were sustainable. So long as expected returns in these countries were relatively high and the guarantees remained credible, these stop-gap measures seemed to work well. Capital inflows and economic growth increased throughout the early 1990s. When coupled with the commitment to pegged nominal exchange rates, however, this approach often resulted in over-valued real exchange rates that reduced expected returns, altering expectations and increasing the volatility of inflows. Once shifts in sentiment occurred, the guarantees on liabilities were tested, creditors ‘ran for the exits’, capital flows reversed, and the scramble by large international creditors to reduce exposure spread contagion as loans were called from all countries perceived to be in ‘the same asset class.’ The recent crises highlighted the failure of these guarantees, their link to contagion, and the need for fundamental financial market reform.

Figure 1: Capital Inflows and The Risk-Return Trade-off



APPENDIX B

Some Suggestion on Arrangements for IMF Lending

Consideration should be given to rationalizing Fund financing to have two principal types of arrangements at its disposal -- a stand-by arrangement linked to an IMF adjustment program with macroeconomic conditionality and a precautionary arrangement for a member country that has satisfied certain stringent eligibility criteria. Both types of arrangements would be short-term in nature, be strictly limited in terms of access, and involve rates of charge sufficiently high to ensure that official lending is not a substitute for private capital.

Stand-by arrangements

Traditional stand-by arrangements (SBA) would continue to be used for member countries that approached the Fund with balance of payments problems, and which had not previously qualified through prior actions for access to a precautionary facility. A country would be eligible for a stand-by, assuming it agreed with the required conditionality, regardless of whether the problem originated in the current account or the capital account. However, access would be strictly limited to, say, the existing cumulative access limit of up to 300 per cent of quota. If this proved insufficient to deal with the problem, external debt service should be rescheduled, if necessary with the help of a standstill.

It should be noted that the 300 per cent of quota would not be an automatic entitlement. Should a country's external debt profile appear unsustainable under reasonable assumptions for external sector adjustment, the Fund should not lend. Additional official assistance for a country in such a position would only add to the country's debt burden. Moreover, since the Fund is considered a preferred creditor, additional Fund loans would reduce the value of existing claims. 'Lending into arrears' should be considered if a debtor country was negotiating in good faith with its creditors for debt reduction.

The SBA could be priced at a penalty interest rate that would rise over time in order to discourage misuse and to encourage early repayment. One could, for example, use the rate of interest for drawings under the existing Supplementary Reserve Facility. Repayment would be obligatory after 2-2.5 years.

Precautionary arrangements

A precautionary arrangement, such as the existing contingent credit line (CCL) could also be useful for countries that are willing to adhere to tough eligibility requirements. Such requirements should include, among other things, adherence to key international codes and standards, a sustainable exchange rate regime, and the willingness to include collective action clauses in its bond covenants. Given the need to satisfy the eligibility requirements, countries could be rewarded with a larger access limit, say 500 per cent of quota, and a more attractive interest rate, say beginning at 200 basis points above the normal rate of charge. Access would be automatic in the event of a crisis. Again, should 500 per cent of quota not be sufficient to satisfy a country's foreign exchange needs, it would have to negotiate a rescheduling, which might involve a standstill. As with purchases under stand-by arrangements, we would recommend a short maturity of 2-2.5 years.

Concerns have been raised about the usefulness of the CCL because of the 'exit problem' -- how to disqualify a country whose policies have slipped. In our view, this should not be viewed as a serious impediment. The potential to publicly disqualify a country would put teeth into the process. If publication should provoke a crisis, so be it. Hopefully, however, serious crises would be infrequent, since more timely and complete flow of information about a country's circumstances should permit markets to adjust more smoothly than in the past. Moreover, the country in question could always apply for a stand-by arrangement, thereby indicating to markets its determination to correct its shortcomings.

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